In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 475

NATHANIEL C. WOOD AND GERTRUDE L. WOOD,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question here is whether payments petitioner[1] received for the right to mine and remove sand and gravel in his land were capital gain, as he claimed, or ordinary income, as the court of appeals held.

Petitioner executed a "lease" that gave the "lessee" the right to mine and remove sand, gravel and rock from petitioner's land for an indefinite period, in consideration of a royalty of 25 cents per cubic yard removed. The "lessee" guaranteed an annual minimum

[1] Since Mr. Wood was the only active party in the transactions involved, he is referred to as "the petitioner". Mrs. Wood is a party solely because joint returns were filed for the years in question.

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payment of $15,000 as long as production continued. Petitioner, in his income tax returns for 1958, 1959 and 1960, reported the royalties as depletable ordinary income. Then, however, petitioner claimed a refund, arguing that he is entitled to capital gains treatment, on the theory that for tax purposes the agreement effected an outright "sale" of the mineral deposits in place. The court of appeals, affirming the district court, held that petitioner had not sold the deposits; that he had retained his "economic interest" in the minerals, under this Court's definition of the term, because the royalties depended on extraction; and that the payments were consequently ordinary income subject to the depletion allowance. This decision is sound and there is no appropriate ground for further review.

1. In a long line of cases this Court has made clear that the grantor of rights to exploit the mineral potential of the grantor's real estate receives ordinary income subject to depletion if the transaction leaves him with an "economic interest" in the minerals in place. In the language of *Palmer* v. *Bender*, 287 U.S. 551, 557, the transferor in such situations receives ordinary income and not capital gains if he "has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."

Petitioner's essential contention (Pet. 5–6) is that he did not retain "income derived from the extraction" of the sand and gravel because his compensation

was a fixed amount per ton, rather than "related solely to payments in kind or to the market value of the minerals when produced." We submit, however, that the import of this Court's decisions is whether the grantor continues to depend solely upon the extraction of the minerals for a return of his capital investment, *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 314, and that this required dependence may take a variety of forms. Thus the decisions have found the requisite interest present when the transferor's interest is payable in cash rather than kind, *Helvering* v. *Twin Bell Syndicate*, 293 U.S. 312, or represents a percentage of the gross revenue, *Burnet* v. *Harmel*, 287 U.S. 103; *Palmer* v. *Bender*, *supra*, or of the net profits, *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 559; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25.

It is equally clear that the transferor receives depletable ordinary income, rather than capital gains, when, as in the present case, his receipts are a fixed amount per ton of minerals removed. This was indeed the holding in *Bankers Coal Co.* v. *Burnet*, 287 U.S. 308, a case decided but a month before *Palmer* v. *Bender*, *supra*. There, as in the case at bar, the taxpayer had transferred operating rights in hard minerals—coal deposits—in consideration of a per ton "royalty" with a minimum annual payment guaranteed. The taxpayer contended that the "royalty" payments were capital gain from a sale. This Court rejected the contention and, relying upon *Burnet* v. *Harmel*, *supra*, a case involving oil and gas royalties

that were a percentage of the transferee's gross proceeds, said (287 U.S. at 311):

> The considerations which led to the conclusion that bonus and royalties paid to the lessor of Texas oil lands are taxable income and not a conversion of capital, as upon a sale of capital assets, are equally applicable to West Virginia coal leases, whether the title to the coal in place passes to the lessee at the date of the lease, or only upon severance by the lessee.

See also *Palmer* v. *Bender, supra,* at 558, and *Douglas* v. *Commissioner,* 322 U.S. 275, 280.

Accordingly, the court of appeals properly ruled here that petitioner's royalty was depletable ordinary income. Recent appellate decisions in four other circuits are squarely in accord. See *Royalton Stone Corp.* v. *Commissioner,* 379 F. 2d 298 (C.A. 2), petition for certiorari pending, No. 604, this Term; *Laudenslager* v. *Commissioner,* 305 F. 2d 686 (C.A. 3), certiorari denied, 371 U.S. 947; *Schreiber* v. *United States* (C.A. 7), decided July 17, 1967 (20 A.F.T.R. 2d 5126); *Freund* v. *United States,* 367 F. 2d 776 (C.A. 7), *Rabiner* v. *Bacon,* 373 F. 2d 537 (C.A. 8).

2. Petitioner asserts (Pet. 11) a conflict with the decision of the First Circuit in *Linehan* v. *Commissioner,* 297 F. 2d 276, and that of the Ninth Circuit in *Gowans* v. *Commissioner,* 246 F. 2d 448. The same contention is made in the pending petition for certiorari in *Peeler* v. *United States,* No. 471, this Term, a case that the Fifth Circuit considered and decided as a companion to this one. For our response, we

refer this Court to the discussion of *Linehan* and *Gowans* at pp. 4–8 of our memorandum in opposition [2] in No. 471.[3]

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[2] Copies of that opposition are being served on counsel for petitioner here.

[3] The decision below is not, as petitioner suggests (Pet. 6), inconsistent with this Court's decisions in *Parsons* v. *Smith*, 359 U.S. 215, and *Paragon Coal Co.* v. *Commissioner*, 380 U.S. 624. The holdings in those cases were that contract miners, who purchased no interest in coal lands but agreed to extract the mineral and deliver it to the owners at a fixed price per ton, did not have an economic interest that entitled them to depletion. The principal focus was whether the contract miners, through their purchase of mining machinery, had "acquired, by investment, any interest in the oil in place," *Palmer* v. *Bender*, *supra*, at 557. Here, in contrast, petitioners do not deny that they had such an interest, but base their claim of capital gains on the argument that they were not depending on extraction for return of their investment (Pet. 6).

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